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IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 26

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

HENRY HARMEL.

Reply to Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

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No. 824.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

HENRY HARMEL.

Reply to Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

QUESTION PRESENTED.

The question presented is whether a cash consideration received by the owner of lands situated in Texas for the execution of an instrument commonly known as an "oil and gas lease," which, under the law of Texas conveys title to the oil and gas in place, is taxable as the "gain derived from the sale or exchange of capital assets" under Section 208 of the Revenue Act of 1924. "Capital assets" are defined in the statute as "property held by the taxpayer for more than two years."

It is admitted that the cash received is taxable income. If it is income from the sale of capital assets it is taxable at the flat rate of 12½ per cent provided in Section 208.

No question is presented regarding the taxing of any royalties which may have been received under the instrument.

STATUTES.

REVENUE ACT OF 1924:

"Sec. 208. (a) For the purpose of this title—

"(1) The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921; * * *

"(8) The term 'capital assets' means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the tax-payer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

"(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

"A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain."

STATEMENT.

The Respondent, Henry Harmel, resides at Megargel, Texas. In 1924 he was, and had been for many years, the owner in fee simple of certain lands located in

Archer County, Texas. In 1924 he executed two oil and gas leases (R. 25-34) covering the land. In consideration therefor he received $57,000.00 in cash.

The Respondent, in his income tax return for 1924, treated this entire sum as capital gain under Section 208 of the Revenue Act of 1924. The Commissioner of Internal Revenue held it was not capital gain and was taxable at ordinary rates. The Board of Tax Appeals affirmed the Commissioner (R. 14-18), 19 B. T. A. 376, and the Circuit Court of Appeals for the Fifth Circuit reversed the Board (R. 35-36).

One of the instruments in question provides that the Respondent, styled Lessor, "for and in consideration of Twenty Thousand and no/100 Dollars, and other considerations hereinafter set forth cash in hand paid, the receipt of which is hereby acknowledged, and of the covenants and agreements hereinafter contained on the part of the lessee to be paid, kept and performed, has granted, demised, leased and let, and by these presents does grant, lease and let, etc." (Record 25-26)

The other considerations referred to are stated in the instrument to be: "The other consideration above mentioned is the sum of $20,000.00 which shall be paid to the lessor hereof out of one-half of seven-eighths of the first oil produced on said land." (Record 29)

The other instrument provides "That the said lessor, for and in consideration of Forty-four Thousand and no/100 Dollars cash in hand paid, and the consideration hereinafter named, receipt of which is hereby acknowledged and of the covenants and agreements hereinafter contained on the part of the lessee to be paid, kept and performed, has granted, conveyed, demised, leased and let, and by these presents do grant, convey, demise, lease and let, etc." (Record 30)

The further consideration referred to in this instance was $44,000.00 to be paid the lessor "out of one-half of seven-eighths of the first oil produced from said land

and a vendor's lien is retained against said leasehold estate and the oil produced therefrom until the full sum of Forty-four Thousand Dollars is paid." (Record 33)

Each instrument provides for royalties as follows:

(a) one-eighth of all oil produced;
(b) One-eighth of the value at the well of gas produced from gas wells; and
(c) One-eighth of the value of gas produced from oil wells and used off the premises,

(Record 26, 27, 31)

ARGUMENT.

1.

The petitioner predicates his application for a writ in this case upon the conflict of the decision below with the decision of the Court of Claims in *Hirschi v. United States,* 67 Ct. Cls. 637 (decided May 6, 1929; certiorari denied 280 U. S. 576). Since the Hirschi decision this Court has settled the law which controls this case, as will be shown hereafter. It is, therefore, submitted that this conflict does not require the granting of the writ.

In this case the Court below held that the consideration received by the Respondent for executing the instruments set out in the statement was taxable at the flat rate of 12½ per cent as a "capital gain" under the Statute (Sec. 208, Revenue Act of 1924) which defines "capital gain" as "taxable gain from the sale or exchange of capital assets" and then defines "capital assets" as "property held by the taxpayer for more than two years". The Court reached this conclusion because of the settled law of Texas that such an instrument conveyed to the so-called lessee title to the oil and gas in place and was, therefore, a "sale" within the terms of the Statute. This opinion merely followed and re-affirmed the conclusions reached by the same Court in 1930 in *Ferguson v.*

Commissioner, 45 F. (2d) 573. The Government did not ask for a rehearing nor for certiorari in the Ferguson case.

In the Hirschi case, decided in 1929, the Court of Claims held that such gains were not capital gains, but were to be taxed at ordinary rates, refusing to give effect to the Texas law and treating the question as foreclosed by the decisions of this Court holding that the income from mining operations was taxable under the 1909 Corporation Excise Tax Law and the Revenue Act of 1913, without deduction for the value of the ore in place (*Stratton's Independence v. Howbert* 231 U. S. 399; *Stanton v. Baltic Mining Co.,* 240 U. S. 103; *VonBaumbach v. Sargent Land Co.* 242 U. S. 503; *U. S. v. Biwabik Mining Co.,* 247 U. S. 116).

That the local law is to be applied to determine whether or not a sale has taken place (in order to determine the incidence of a Federal tax where Congress has not put into the Act criteria for determining the question) has been quite recently decided by this Court in an almost identical situation (*Group No. 1, Oil Corporation v. Bass,* 283 U. S. 279). In that case this Court, in determining whether or not the income from the oil leases there involved was taxable under Federal Revenue Laws, held that the oil leases there involved were "present sales to the lessees, upon the execution of the leases, of the oil and gas in place" (page 281), upon the authority of *Theisen v. Robison,* 117 Texas 489. This, the Court said, was the settled law of Texas as announced in *Texas Company v. Daugherty,* 107 Texas 226, and *Stephens County v. Oil & Gas Company,* 113 Texas 160. Therefore this Court held that the lessees were taxable upon the income derived from the oil-producing operations conducted on these lands even though the lands in question were University lands belonging to the State of Texas and, but for this rule, the income in question might have been exempt from taxation.

This express recognition that State rules of property must be looked to in determining the incidence of a Federal tax where, as here, the ownership of real estate is the controlling question and Congress has not seen fit to limit the general terms used, carries out the principle applied by this Court in the Community Property cases (*Poe v Seaborn*, 282 U. S. 101, and other cases decided the same day; *U. S. v. Malcolm*, 282 U. S. 792; compare *Robbins v. U. S.*, 269 U. S. 315).

These very recent decisions by this Court so plainly authorize and compel the conclusions reached by the Court below, that it would appear unnecessary for this Court to grant the writ prayed for in order to resolve the conflict with the Hirschi case decided before the decisions above referred to.

2.

It is further submitted that a conflict between the decision of a Circuit Court of Appeals and the Court of Claims is not a reason for granting a writ of certiorari within Rule 38, paragraph 5 (b) of this Court.

3.

Stratton's Independence v. Howbert, 231 U. S. 399; *Stanton v. Baltic Mining Co.*, 240 U. S. 103; *VonBaumbach v. Sargent Land Co.*, 242 U. S. 503; and *U. S. v. Biwabik Mining Co.*, 247 U. S. 116; are not in conflict with the decision in this case. As heretofore stated, they arose under the Corporation Excise Tax Law of 1909 and the Revenue Act of 1913. In none of these acts were capital gains taxed differently from recurring gains. The capital gains feature of the law was first introduced into the Federal taxation in the Revenue Act of 1921, long after these cases were decided.

All dealt with the income from mining operations and not with transfers of mining property. The basic ques-

tions involved were entirely different. In some of the cases the question was whether the Excise Tax Law applied to mining companies. In others the question was whether the proceeds of ore mined constituted income and whether such corporations were entitled to deduct from the proceeds so received the value of the ore in place in arriving at the income to be taxed. In the *Stanton* case, under the Revenue Act of 1913, the question was whether the failure to allow more than five per cent of the value of the product for depletion rendered the tax a direct one on property and unconstitutional. In one case (*Stratton's Independence*) the mine was owned in fee. *Sargent Land Co.* was a lessor, and that case dealt with royalties on ore extracted by the lessee. The *Biwabik Mining Company* was a lessee and the precise question was whether, under the 1909 Act, it had the right to deduct from gross income the value in place,—not cost, of the ore mined.

Plainly these decisions have no bearing upon the question decided by the Court below, and the Lower Court's decision is not in conflict with them.

4.

The various decisions of other Circuit Courts and the Court of Appeals of the District of Columbia cited by the petitioner do not conflict. The majority of these, instead of dealing with the question at issue here, deal with the proper method of taxing the royalties received from oil-producing operations. In fact, no showing was made in this case as to whether any oil was ever produced under the leases in question and the leases themselves show that no royalties were to be paid except upon and as oil and/or gas were actually produced. This is applicable to the following cases cited by the Petitioner: *Murphy v. Commissioner* (App. D. C.), decided Feb. 20, 1930, and reported at 2 Prentice-Hall 1930, p. 1963 affirming *J. E.*

Murphy v. Commissioner, 9 B. T. A. 610; *Reynolds v. Commissioner* (App. D. C.), decided Feb. 20, 1930, without opinion and affirming *J. D. Reynolds v. Commissioner,* 10 B. T. A. 651; *Alexander v. King* (C. C. A. 10th), 46 F. (2d) 233 (certiorari denied 283 U. S. 845).

While *Burkett v. Commissioner,* 31 F. (2d) 667, and *Berg v. Commissioner,* 33 F. (2nd) 641, decided that the consideration received for the execution of the oil leases there involved were not to be taxed as capital gain, neither conflicts with the decision below in this case because both involved land in Arkansas and the courts which decided those cases were not called upon to determine the basic question here involved, that is,—What is conveyed by such instruments in Texas?

5.

Rosenberger v. McCaughn (C. C. A. 3d), 25 F. (2nd) 699, and *Bankers Pocahontas Coal Co. v. Commissioner* (C. C. A. 4th), 55 Fed. (2d) 626, dealt with the proper method of taxing one who, prior to March 1, 1913, acquired the right to receive royalties from a coal mine upon payments received subsequent to March 1, 1913. The question of taxing the proceeds from the transfer of mining property is not involved. In each case it is clear that the same result would have been reached had the original leases (made before March 1, 1913) been considered sales of the ore in place and the royalty payments the consideration therefor, for certainly there is the same element of profit in the deferred consideration when collected.

6.

Burk-Waggoner Oil Association v. Hopkins, 269 U. S. 110, presented an entirely different question. There it was held that the fact that a joint stock association was, under the law of Texas, a partnership, did not deprive

Congress of the power to classify it as a corporation for the purpose of imposing the tax and did not render unconstitutional the tax upon its income. No question is presented in the case at bar as to Congressional power. Admittedly Congress could refuse to extend the benefits of the capital gains sections to transactions like those involved here, just as it refused to extend them to property not owned for two years, or to "property held primarily for sale in the course of his trade or business", (Sec. 208(a)(8), Revenue Act of 1924). But until Congress sees fit to limit the meaning of "sale or exchange" or "capital assets", the question presented in the *Burk-Waggoner* case will not arise.

In *Weiss v. Weiner,* 279 U. S. 333, it was expressly stated that the Act of Congress had provided its own criteria for determining under what circumstances depreciation deductions would be allowed and, therefore, the fact that, under the law of Ohio, long-term leases upon real estate were treated in many respects like conveyances of the fee was unimportant in determining to whom and under what circumstances the statutory depreciation deductions were to be allowed. The decision of the Court below does not conflict with decisions like these.

7.

In *Work vs. Mosier,* 261 U. S. 352, the Court was dealing neither with a problem of taxation nor with any local law relating to oil and gas leases. Instead, the Court was construing an ambiguous statute relating to the disposition of tribal lands and funds of the Osage Indians, and resolved the ambiguity in a way thought more nearly to carry out the congressional intention.

Congress, by Statute passed in 1906, had provided for the division of the lands and funds of the Osage Indians in Oklahoma Territory among the members of that Tribe, the lands to be divided by selection. The same Act forbade the sale of oil and other minerals in the lands and

reserved these minerals, and the uses and benefits arising therefrom, for the Tribe as a whole for a period of twenty-five years, the Act providing that for that period the royalties should be paid to the Tribe and that at the end of the twenty-five year period the oil and other minerals should become the property of the individual allottees of the land, unless otherwise provided. It was also provided that periodical distribution of the royalties received should be made to the members of the Tribe and that the amount of these royalties were to be fixed by presidential decree.

The unforeseen condition which arose, as is disclosed by the opinion of the Court, was that large sums were received as bonuses in the sale of such leases, which were made at public auction. In this situation it became necessary for the Court to determine whether, under this Statute, these bonuses should be distributed among the members of the Tribe during the twenty-five year period, or whether they should be withheld during such period and, at the end thereof, go to the individual allottee from whose land the oil was produced. It was clearly the purpose of Congress that the benefits of such minerals as might be developed under the entire land should go to the Tribe as a whole during the twenty-five year period, and not to those particular allottees who were fortunate enough to receive as their allotment a tract of land later discovered to contain minerals. Under these circumstances, the Court said (page 357):

> "But, in the unexpected event, we must decide under what head the bonus is to be treated,—whether as capital or income,—and it seems clear to us that, in view of the entire statute, it is more aptly described by the latter term."

It was only by reaching this conclusion that the intention of Congress,—that the entire Tribe, rather than indi-

vidual allottees should share in all of the benefits obtained from the minerals,—could be carried out.

We also call the Court's particular attention to the discussion of this case in *Ferguson vs. Commissioner,* 45 Fed. (2) 573, 576-7.

8.

The Board of Tax Appeals is now following the Ferguson decision in cases arising in Texas. *Waggoner v. Commissioner,* 24 B. T. A. 657; *Tippett v. Commissioner,* 25 B. T. A. 69.

CONCLUSION.

The Court below followed the very recent rulings of this Court in deciding the question presented. It would appear that there is no further room to question the soundness of that decision and that, without further action by this Court, the principles decided below in this case and the Ferguson case, will be followed. Therefore, it is unnecessary for this Court to further review this case.

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April, 1932.